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In the Supreme Court of the United States

OCTOBER TERM, 1933

Nos. 129–131

JOHN FREULER, ADMINISTRATOR OF THE ESTATE OF Louise P. V. Whitcomb, petitioner

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 32–53) is reported in 22 B.T.A. 118. The opinion of the Circuit Court of Appeals (R. 154–160) is reported in 62 F. (2d) 733.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 9, 1933 (R. 161). The time within which a petition for certiorari might be filed was extended by a Justice of this Court to include June 8, 1933. The petition for writs of certiorari was filed June 6, 1933. The jurisdiction of this

Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

A life beneficiary of a testamentary trust received and retained before and during the taxable years the full amount of her distributive share of the trust income undiminished on account of a depreciation reserve or otherwise.

The question presented is whether the taxable status of income thus received was altered by the entry of a probate court order in a friendly settlement of the trustee's account, some years after the taxable period, holding that depreciation should have been deducted, and in pursuance of which a small, unidentified sum was repaid to the trustee, on account of a depreciation reserve.

STATUTES INVOLVED

The statutes involved will be found in the Appendix, *infra*, pp. 17–18.

STATEMENT

The facts are not in dispute and so far as material may be summarized as follows:

From 1889 until her death on June 14, 1921, Louise P. V. Whitcomb was the widow of A. C. Whitcomb who died testate a resident of California (R. 34). By his will, A. C. Whitcomb created a trust in which his widow and two children, Adolph and Charlotte Andree, were life beneficiaries (R. 34-35). After the death of Adolph in 1914, his share of the income was

paid to his widow, Marguerite T. Whitcomb, and to his two children Lydia L. Whitcomb and Louise A. F. E. Whitcomb (R. 36–37). The will contained no directions with respect to the manner in which the trust income should be computed, accounts kept, or depreciation provided for (R. 35).

The trust property originally consisted chiefly of non-depreciable assets, but improved real estate subject to depreciation was substituted by a process of gradual conversion (R. 35–36; 68–72). The successive trustees accounted annually until 1902 but no formal account was filed thereafter until 1928 (R. 38, 110). The surviving trustee filed fiduciary returns for the years 1921 to 1926, inclusive, involved in these cases, deducting in the computation of the net income of the trust an amount representing exhaustion, wear, and tear sustained by the trust property. He did not withhold from the beneficiaries to whom income payments were being made the amount covered by the depreciation deduction and each of the beneficiaries received his or her ratable share thereof during the taxable period just as in all preceding years. (R. 37–38.)

Certain of the beneficiaries, including the petitioner's decedent, disputed the determination made by the Commissioner of Internal Revenue for the years 1917 to 1920, inclusive, each contending that she was wrongfully taxed in those years in respect to depreciation which had been allowed as a deduction in determining the net income of the trust for the corresponding years. The Board of Tax Appeals

approved the Commissioner's determination in these cases, concluding that depreciation, which affects only capital assets and not income, may not be deducted by life beneficiaries. *Appeal of Louise P. V. Whitcomb*, 4 B.T.A. 80; *Marguerite T. Whitcomb* v. *Commissioner*, 5 B.T.A. 191, affirmed *sub nomine Whitcomb* v. *Blair*, 25 F. (2d) 528 (App.D.C.).

On September 5, 1928, more than two years after the assertion of the deficiency against this petitioner and five months after the decision of the Court of Appeals in *Whitcomb* v. *Blair*, *supra*, the trustee filed his account for the period February 23, 1903, to February 23, 1928, and prayed for its approval (R. 110–128, 136). The remaindermen, Napoleon Charles Louis Lepic and Charlotte de Rochechouart, aliens residing in France, filed objections to the account covering the years 1913 to 1927, inclusive, on the second day after it was filed (R. 129–132, 136). The trustee answered four days later (R. 133–135). On September 19, 1928, the court entered a decree (R. 136–139) in which it set forth the amount of depreciation of the property of the trust from 1913 to 1927 as determined by the United States Government in connection with the income-tax returns of the trust and sustained the remaindermen's objections to the trustee's account in so far as the trustee had failed to withhold from distribution to the beneficiaries amounts sufficient to offset the depreciation sustained by the trust property. The beneficiaries were ordered to repay to the trustee the overpayments they had received during the years.

1913 to 1927 on this account "by making, executing and delivering to said Trustee their respective promissory notes, payable without interest at the termination of said trust to the order of the remaindermen" (R. 138–139). An amended order filed the same day eliminated reference to the proposed notes (R. 140–144). Notes were in fact executed by or on behalf of the several beneficiaries other than the petitioner's decedent (R. 145–148). Although Napoleon Charles Louis Lepic and Charlotte de Rochechouart were remaindermen and not life beneficiaries and hence in receipt of no income from the trust they joined in the note of their mother, Countess Charlotte Andree Whitcomb Lepic (R. 145). A payment of $10,700 was made to the trustee by the estate of Louise P. V. Whitcomb (R. 42). The record does not disclose on what account or with respect to what year or years this payment was made.

The life beneficiaries did not include in their returns for the years in question the amounts paid to them by the trustee which reflected their proportionate shares of the depreciation sustained and deducted on the fiduciary returns of the estate. The Commissioner of Internal Revenue increased the income shown on the several returns by the addition of these amounts and determined deficiencies accordingly (R. 42). The Board of Tax Appeals, six members dissenting, set aside the determination of the Commissioner (R. 42–54). The Circuit Court of Appeals reversed the order of the Board (R. 161).

ARGUMENT

The petitioner's decedent was a life beneficiary of a testamentary trust. The trust did not in terms require the trustees to set aside a reserve on account of depreciation. Nor can such a provision be read into the instrument, for there were no depreciable assets in the estate when the trust was created. For some thirty years prior to the taxable period the life beneficiaries, including the petitioner's decedent, received and retained the full amount of their distributive shares of the trust income without question. The propriety of taxing the full amount of these distributions to the recipients was tested in *Whitcomb* v. *Blair*, 25 F. (2d) 528 (App.D.C.), and *Appeal of Louise P. V. Whitcomb*, 4 B.T.A. 80.[1] These decisions held that the distributive shares of the beneficiaries must include what they actually received and that depreciation, which affects only capital assets and not income, may not be deducted by life beneficiaries.[2] The earlier rulings serve to narrow the

[1] *Whitcomb* v. *Blair* related to the 1918 tax against Marguerite T. Whitcomb. *Appeal of Louise P. V. Whitcomb* related to deficiencies asserted against Louise P. V. Whitcomb (petitioner's decedent) and Charlotte A. W. Lepic for 1917, 1918, 1919, and 1920, and Marguerite T. Whitcomb for 1919 and 1920.

[2] The same result has been reached in many other cases: *Baltzell* v. *Mitchell*, 3 F. (2d) 428 (C.C.A. 1st), certiorari denied, 268 U.S. 690; *Codman* v. *Miles*, 28 F. (2d) 823 (C.C.A. 4th), certiorari denied, 278 U.S. 654: *Abell* v. *Tait*, 30 F. (2d) 54 (C.C.A. 4th), certiorari denied, 279 U.S. 849; *Kaufmann* v. *Commissioner*, 44 F. (2d) 144 (C.C.A. 3d); *Hubbell* v. *Burnet*, 46 F. (2d) 446 (C.C.A. 8th), certiorari denied, 283 U.S. 840; *Codman* v. *Commissioner*, 50 F. (2d) 763 (C.C.A. 1st); *Roxburghe* v. *Burnet*, 58 F. (2d) 693 (App. D.C.), certiorari denied, 286 U.S. 567; *Roxburghe* v. *United States*, 64 C.Cls. 223.

issue, so that it is now necessary to inquire only whether the court below erred in declining to hold that the opposite result must now be reached as a result of the judgment of the State probate court.

Even if it be assumed that this is a case where the operation of the Federal taxing statute is by necessary implication made dependent upon local law (*Burnet* v. *Harmel*, 287 U.S. 103), there is no adequate showing that the local law requires a conclusion different from that reached below. The petitioner cites only one local decision to show the existence of a State rule of property, *Estate of Gartenlaub*, 185 Cal. 648. That case holds that in California a trustee is required to set aside from income amounts adequate to amortize the premium paid upon the purchase of bonds. We do not question the correctness of that decision; we do question its application to the present situation.

Nor is the petitioner's case established by the order of the state probate court entered with respect to this particular trust. That order is not controlling here on the basis of *res adjudicata*, because the United States was not and could not have been a party to the proceeding in which it was entered. It is equally obvious that the decision is not binding here as an *in rem* decree; there was no *res*, no question of title to specific items of property. The only effect therefore which can be given to the order is that resulting from the consideration and respect which is always accorded to the decisions of

State courts. Even a decision by the highest court of a State is not binding when the same question is presented in a Federal court unless it involves a construction of a State constitution or statute, a decision on descent and distribution under State laws, or unless it is part of a series of decisions constituting a well-established State rule of property. *Burgess* v. *Seligman,* 107 U.S. 20; *Barber* v. *Pittsburgh &c. Ry.,* 166 U.S. 83; *Kuhn* v. *Fairmont Coal Co.,* 215 U.S. 349; *B. & W. Taxi Co.* v. *B. & Y. Taxi Co.,* 276 U.S. 518, 529–531. In *Lane* v. *Vick,* 3 How. 464, 476, this Court said:

> * * * this court do not follow the state courts in their construction of a will or any other instruments, as they do in the construction of statutes.

And in *Barber* v. *Pittsburgh &c. Ry., supra,* the same rule was repeated (p. 100):

> But a single decision of the highest court of a State upon the construction of the words of a particular devise is not conclusive evidence of the law of the State, in a case in a court of the United States, involving the construction of the same or like words, between other parties, or even between the same parties or their privies, unless presented under such circumstances as to be an adjudication of their rights.

The question involved in the State decree here was perhaps not strictly one of the construction of language in a will, but rather one of the rule to be

applied where the will contained no express provision. But in the absence of a well-defined State rule of property, State decisions are not binding on the Federal courts in either class of cases.

The decision below is not only in accord with these decisions of this Court, but it is directly supported, we submit, by another case involving facts closely similar to those here presented. *Ford* v. *Commissioner,* 51 F. (2d) 206 (C.C.A. 6th), certiorari denied, 284 U.S. 666. There executors made distribution of certain stocks to named beneficiaries in 1920 who received substantial dividends thereon in 1922. The distribution was premature as a matter of State law and in 1926 the appropriate probate court undertook, apparently on its own motion, to set the distribution aside ordering it to have been "without authority, illegal and of no effect" (p. 207). The distributees were commanded to account to the executor for the principal and income from the date of distribution. The matter was handled entirely by book entries. The Circuit Court of Appeals, in upholding the taxation of the dividends to the beneficiaries, clearly indicated the proper criterion to be the actual receipt and retention during the year in question of what is then considered to be income. The court said (p. 207):

> If taxes regularly assessed could be invalidated, an indefinite number of years later, by a consent judgment purporting to vacate the title of the taxpayer to the fund he had reported as income, the necessary system of tax collection would be much impaired.

See also *Jackson* v. *Smietanka*, 272 Fed. 970 (C.C.A. 7th); *Wear* v. *Commissioner* (C.C.A. 3d), decided May 26, 1933, not yet reported but may be found in 333 C.C.H. 8858.

The petitioner asserts several conflicts. But all of the cases relied on are, we submit, distinguishable. In *Uterhart* v. *United States*, 240 U.S. 598 (cited at Pet. 9), there had been a decision of the State court as to the meaning and effect of certain provisions in a will at the time of probate. The question presented to this Court was the application of the Federal legacy tax to the interests so established. The United States admitted the State decree to be binding (240 U.S. at 603). If the language of the court orders upon which the petitioner here relies had been incorporated in the decree of distribution, and if thereafter distribution had been made in accordance with such orders, the *Uterhart case* might be in point. However, the decree of distribution no more requires the creation of a reserve for depreciation than the will itself. (See R. 100–101.) In reality it sanctioned the course actually followed by the trustee for more than a third of a century. Years after the rights of the United States attached, the State court attempted by means of a proceeding to which the United States was not a party to deprive it of rights already accrued under a Federal statute.

We submit that the two situations are clearly distinguishable.

Commissioner v. *Field,* 42 F. (2d) 820 (C.C.A. 2d), also relied upon by the petitioner as creating a conflict (Pet. 9), seems likewise distinguishable. There the taxpayer was the beneficiary of a trust created by the will of his deceased grandfather. Prior to the taxable year involved (see 15 B.T.A. 718), a decree had been entered by a state court of competent jurisdiction construing the will and ruling that the taxpayer received his interest free of any restraints on alienation. Thereafter, the taxpayer assigned a portion of his interest, and he did not in fact receive the income from this portion in the year in question. The question presented in the Federal court was whether the taxpayer was nevertheless taxable on this assigned income. Since the decree of the state court was entered before the tax year involved, and since the taxpayer never in fact received the income in question, the decision is obviously distinguishable, we submit, from the present case where the taxpayer received and enjoyed the income and the decree of the state court was not obtained until after the tax controversy had arisen may years later.

Brief mention is also made (Br. in Sup. 17–18) of an earlier case, *McCaughn* v. *Girard Trust Co.,* 19 F. (2d) 218 (C.C.A. 3d). This was a suit for the refund of taxes paid on property held by a

trustee for accumulation. It was subsequently held by a court of competent jurisdiction that the accumulation provisions of the will were invalid and that the testator died intestate with respect to the residue. There seems to be little analogy between a case where the instrument in question is void upon its face and a case in which it is entirely valid and distribution is made in pursuance of its literal terms for a period of more than 30 years without question from any quarter. Furthermore, the opinion of the Circuit Court of Appeals in the *Girard Trust Company case* does not disclose passive acceptance of the state court order, but rather an independent decision of the question on the merits.[3] Even if the case is in point, which we do not concede, there would appear to be considerable doubt of the soundness of the decision, which depends upon the doctrine of "relation back." This Court has since declined to apply that doctrine in *Ithaca Trust Co.* v. *United States*, 279 U.S. 151, and *Lucas* v. *American Code Co.*, 280 U.S. 445. In the former case one of the questions was the determination of the value of a life estate. The Court rejected the contention that the value could be fixed

[3] "Referring to this decree, the court below said, and we agree thereto, that 'this will sins against the policy of the law and the statutes enacted to enforce it is in effect admitted. That policy and these statutes nullify all provisions of wills which create perpetuities and limit accumulations to a prescribed period of time.'" 19 F. (2d) 218.

by reference to the actual life span of the tenant rather than by recourse to data as of the death of the testator when the tax liability arose.

Several very recent decisions will be referred to briefly. In *Fidelity & Columbia Trust Co.* v. *Lucas*, decided by the Circuit Court of Appeals for the Sixth Circuit on June 29, 1933, not yet reported but may be found in 333 C.C.H. 9093, the court, Judge Moorman dissenting, reversed the decision of the District Court, 52 F. (2d) 298 (W.D.Ky.). In the view of the court, the case presented a question of the proper construction of a will. The District Court rejected the taxpayer's contention that the judgment of a state probate court obtained at the instance of the trustee after the deficiency assessment was made was binding upon the Federal court when the tax question was in litigation. While the Circuit Court of Appeals reversed the judgment of the District Court, it did so as the result of an independent construction of the will, not because of any supposed binding effect of the ruling of the local court. Thus there is no conflict between that case and the present case.

We of course concede that there are certain types of questions in which the decisions of local courts of competent jurisdiction are controlling. Among cases of this character are those involving questions of the construction of state constitutions and stat-

utes, and of descent and distribution under state laws. *Pitman* v. *Commissioner,* 64 F. (2d) 740 (C.C.A. 10th), is a case of the latter sort. The significant inquiry there was the extent and character of the interest of the taxpayer in certain Indian allotments in Oklahoma. A probate court having jurisdiction entered a decree of distribution which recited that the property in question descended to and vested in the taxpayer as sole heir. This occurred before the taxable year. The case did not depend, as does the instant case, upon the law applicable to a will or other written instrument. These considerations, we submit, dispose of any apparent conflict. In *Commissioner* v. *Newport Co.* (C.C.A. 7th), decided July 8, 1933, not yet reported but see 333 C.C.H. 9111, the court denied effect to certain waivers which were executed after a local court having jurisdiction had dissolved the taxpayer's transferor. Corporations are creatures of the States which create them and when a state court of competent jurisdiction decrees that a given corporation has ceased to exist such an order would seem to finally conclude the matter.

A number of Federal tax cases have arisen presenting the question of the conclusive effect of judgments of state courts. It is believed that the controlling principles have been announced by this Court and for the most part properly applied in

the decisions of lower Federal courts. These principles seem to require the conclusion that a decision of a state court which relates to the effect to be given to a particular will or similar instrument in writing will not be deemed conclusive unless it is required by the application of a state rule of property. This seems to be particularly true where, as here, the decision of the state court is announced after the rights of the litigants in the Federal court have attached. These views, if they be sound, distinguish every case which has come to our attention.

Taxation is essentially practical and there is every practical reason for upholding the decision of the court below. If the view of the petitioner were sustained taxes regularly assessed could be invalidated years later by friendly judicial proceedings to which the Government was not a party. Proper administration of the Federal revenues requires that the taxable status of income received and enjoyed during a given year be fixed as of that time rather than as of some later time of the taxpayer's selection.

The decision below is in harmony with that of the Court of Appeals of the District of Columbia in the companion case of *Commissioner* v. *Marguerite T. Whitcomb,* decided May 22, 1833, not officially reported but found in 333 C.C.H. 8840. We respectfully invite the attention of this Court to the opinion of the majority in that case.

CONCLUSION

We submit that the case was properly decided below. There is no conflict of authority and the petition should be denied.

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AUGUST 1933.

APPENDIX

STATUTES INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 246:

SEC. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

* * * * *

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

* * * * *

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to

the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

Revenue Act of 1924, c. 234, 43 Stat. 253, 275:

SEC. 219. (b) Except as otherwise provided in subdivisions (g) and (h), the tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that—

* * * * *

(2) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries, and the amount of the income collected by a guardian of an infant which is to be held or distributed as the court may direct, but the amount so allowed as a deduction shall be included in computing the net income of the beneficiaries whether distributed to them or not. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under paragraph (3) in the same or any succeeding taxable year. (U.S.C., Title 26, Sec. 960.)

Section 219 (b) (2) of the Revenue Act of 1926, c. 27, 44 Stat. 9, 32 (U.S.C.App., Title 26, Sec. 960), is the same as the corresponding subsection of the Revenue Act of 1924.

U. S. GOVERNMENT PRINTING OFFICE: 1939